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REPORT TO THE EXECUTIVE COMMITTEE
OF THE ECONOMIC DEFENSE ADVISORY COMMITTEE

Operations of the Diversion Control Network

October 15, 1954 to July 30, 1955

I. General

During the period under review, the Diversion Control Network held 26 meetings and docketed 104 new cases. As compared with the period covered by the previous report (ED/EC D-58/1, covering DCN operations from May 1, 1954 to October 15, 1954), there has been a marked decline in the number of diversion cases docketed per unit time: between May 1, 1954 and October 15, 1954 an average of about 20 cases per month were added to the DCN case inventory; between October 15, 1954 and July 30, 1955 the average was about 12 per month, and in the last 3 months of this period the average dropped to about 7 per month.

The reasons for this decrease in the number of diversion cases brought to the attention of the DCN are not clear. They may be due to one or more of the following:

(1) More effective enforcement of trade controls following the implementation of the TAC scheme, which took place during the period.

(2) A shift of Soviet bloc clandestine procurement activities to new channels and areas where U. S. intelligence coverage is less effective.

(3) Loss of certain key intelligence sources [redacted] and reduced access to others. 25X1C

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Apart from its basic responsibility for ensuring prompt coordinated action by the cognizant U. S. agencies responsible for preventing diversions of strategic goods to the Soviet bloc, an important function of the DCW is to study the diversion cases that come to its attention in order to ascertain the specific nature and extent of the loopholes in multilateral trade controls revealed by these cases. Several examples occurred during the period under review and are discussed in Section III below.

(4) An actual decrease in the level of illicit procurement activity by Soviet bloc agents (related, possibly, to the Geneva conferences).

(5) Personnel changes at several key Foreign Service posts which may have resulted temporarily in less effective East-West trade intelligence coverage at the posts affected.

II. Analysis of DCN Cases

(Data to be supplied by CIA.)

III. Developments of Special Interest

A. Enforcement Problems Revealed by DCN Cases

1. TAC Loopholes

The TAC scheme was officially implemented by all the COCOM countries on January 16, 1955, some three months after the start of the period under review. Three DCN cases which developed during January-March 1955, served to underline clearly some of the weaknesses in the scheme. These cases were the ALMEX mercury case (DCN #323), the German/Finnish cobalt case (DCN #243), and the Thorium/Cerium nitrate case (DCN #338).

The ALMEX mercury case involved an attempt to divert 100 flasks of Mexican mercury via Rotterdam to Czechoslovakia. The intention to divert was discovered while the shipment was enroute to Rotterdam. Despite a request by the Mexican Government to the Dutch Government that the shipment be held up indefinitely pending investigation, the Dutch took the position that they could only delay the transshipment very briefly because they had no legal basis for either seizure or indefinite delay. It soon became apparent, in the course of the discussions, that -- contrary to the U. S. understanding of the COCOM agreement on TAC -- the Dutch were not prepared to

interpret their TAC regulations in such a way as to permit informal and confidential cooperation by third countries, but required that the names of all cooperating countries be published in a list appended to their regulations. Although the specific diversion case that brought this question to light was resolved satisfactorily as a result of the combined pressures of the U. S. and Mexican Governments on the Mexican exporter, on the one hand, and the Dutch Government, on the other, the enforcement problems revealed by it have not as yet been resolved.

The German-Finnish cobalt case brought out a somewhat different difficulty inherent in the TAC scheme. This case involved a shipment of cobalt from Helsinki to Rotterdam where intention to divert was made known to the United States and Netherlands authorities while the shipment was still on the high seas. The cobalt had been refined by Duisburger-Kupferhuette of Duisburg, Germany from Finnish pyrites cinder and returned to Helsinki under a processing transaction in effect since 1946 between Duisburger-Kupferhuette and Outokumpu Oy of Helsinki. The German Government had issued a license for the export of the cobalt to Finland. The Finns had refused to accept the cobalt when it arrived in Helsinki because no Finnish import license had been issued, and the shipment was "returned to the sender" in accordance with Finnish law. From Finland, the cobalt was declared for Hamburg (the port from which it had been shipped). Actually the shipment was destined for diversion to Gdynia via Rotterdam.

Upon learning of these developments, the German Government officially informed the Dutch Government of the details of the transaction and requested that the Netherlands strictly enforce the TAC scheme in this case.

Despite the German request, the Dutch authorities, although delaying the shipment, refused to give any assurances that they would prevent diversion under the TAC scheme. Their initial objections centered about the adequacy of the proof offered by the German Government that this shipment was in fact subject to the control of the Germans. Later, they held that inasmuch as the cobalt ore originated in Finland, was sent to Germany for processing, and the cobalt metal was then purchased by a Finnish firm, the entire transaction must be regarded as involving third country rather than German provenance. Moreover, when it became clear that the title to the goods was held by a Finnish principal throughout the entire transaction -- and was still held by him -- the fact that the cobalt did not enter the Finnish economy upon arrival at Helsinki did not of itself provide a basis for the Netherlands to invoke TAC. A further complication was introduced when the freight forwarder in Rotterdam announced that he had been instructed to ship the cobalt to a consignee in Vienna. This, of course, strengthened the Dutch position since Austria is not a proscribed destination under TAC. Thus, when the fact of German origin was finally corroborated by the Finns, the Netherlands continued to decline to invoke TAC since the Rotterdam agent claimed the goods were destined for a third country consignee. As in the ALMEX mercury case, although the diversion was effectively frustrated -- the combined pressures of the U. S., Finnish, and German Governments resulted in resale of the goods to a satisfactory consignee -- the TAC loophole brought to light continues to be a matter of concern. (NOTE: an excellent analysis of the enforcement problems involved is contained in Paris POLTO A-88, August 2, 1955.)

The Thorium Nitrate case further underlined the weaknesses in the TAC

scheme. This case started when the Swedish Government informed the U. S. Embassy in Stockholm that they had seized a shipment of thorium nitrate and cerium nitrate in the free port of Malmo. The shipment (which, on subsequent investigation, proved to be of French origin) had arrived from the U. K. and was consigned to Switzerland via East Germany. The fact that the goods were on the atomic energy list and that the routing showed clear intention to divert aroused Swedish suspicions. The goods were then loaded on a Swedish ship bound for the U. K. The ship stopped at Amsterdam enroute where a Dutch freight forwarder, on instructions from the Swiss title-holder, presented the original bill of lading to the captain and had the goods unloaded. They were then shipped to Basel. Part of the shipment was diverted to Czechoslovakia and the balance seized by the Swiss Government (which requires transshipment licensing for atomic energy items).

All three cases point to the necessity for resolving the third country cooperation problem. Moreover, they provide powerful evidence to support the judgment that the adoption of the TAC scheme by the COCOM countries has not eliminated the need for an effective enforcement apparatus.

2. IC/DV Problems

A good example of how a DCN operation uncovered an enforcement loophole, brought it to the attention of the appropriate authorities, and succeeded in stimulating prompt remedial action is provided by DCN Case #287. This case involved two diversions of Northern Rhodesian copper via Sweden and Antwerp. The original information was obtained by the Consulate General at

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Antwerp [redacted]

Subsequent investigation of the leads [redacted]

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showed IC/DV control was not being exercised over Rhodesian copper despite the fact that the U. K. had agreed to obtain British Commonwealth cooperation. The American Consul General in Salisbury reported (Salisbury D-232, March 17, 1955) that when the Government of the Federation of Rhodesia and Nyasaland took over responsibility for the foreign trade of the Federation on July 1, 1954, nothing had been done by the British Colonial office officials in Northern Rhodesia to establish an export control procedure. This situation continued to exist until the Consulate General in Salisbury raised the question of the diversions uncovered by Antwerp. After being apprised of the situation, the Federation Government, obviously embarrassed, acted promptly to institute IC/DV controls.

In contrast to the happy outcome of the Rhodesian situation, the attention of the DCM was drawn during the period to a technique for circumventing IC/DV controls that looks almost fool-proof. It was described in Santiago D-836, May 16, 1955, as follows:

> "The usual procedure is for an offer to be made at a very, very low price, usually for Chilean material, and when a contract is fixed the buyer is requested to supply Import Certificates, declarations of destination, etc. All these documents to be stamped by the Chilean Consulate. When the buyer advises that such documentation is not customary, the seller advises that it is indispensable otherwise the copper cannot be delivered. Naturally the buyer is reluctant to throw away a seemingly handsome profit. What will happen is that the sellers will offer a performance bond usually $12 per ton, against opening of a letter of credit, and then put these certificates, etc. through various channels to obtain the release of the copper in Chile. The copper is then shipped, bills of lading made out as requested, but as the letter of credit is usually in New York, the documents are not immediately presented but pass through other hands on their way to New York. These intermediaries can usually arrange for the consignee to be changed and re-route the material to Rotterdam or Hamburg Free Port with results

> that are not difficult to imagine. The buyer is then told that there have been troubles and the $12 is released to him. Despite all his efforts, he will not get his Import Certificate back again for cancellation. The result is that the buyer, although claiming to be an innocent party, will have his name put down on the international 'black list' and it will be very difficult to prove that he knew nothing about the transaction."

Although the DCN has not been able to come up with specific ~~in~~ evidence to show this technique in actual operation, the relative simplicity of the idea, coupled with the fact that the information was supplied (indirectly) by a member of the London Metal Exchange, make it highly probable that it has been -- and possibly still is -- used.

There does not appear to be any simple way to combat this technique for circumventing COCOM controls. In the case of Chilean copper, it would appear, initially, to require much more enthusiasm for preventing diversions than the obviously reluctant Chilean Government could be persuaded to exercise, considering the essentially pro forma cooperation it has displayed to date. In order to stamp out this practice, the Chileans would have to demand IC's for every shipment, promptly investigate all cases that looked suspicious, and impose severe penalties on all firms convicted of participating in diversions. (This might impose a greater administrative burden on the Chilean Government than is currently borne by any of the COCOM PCs.) Moreover, it would not necessarily prove to be effective because, if cleverly handled, it would probably be extremely difficult to prove culpability of firms or ~~an~~ individuals subject to Chilean control. Thus, extremely close cooperation between the Chilean Government, most COCOM Governments, and key third countries such as Sweden, Switzerland, and Austria in controlling

copper shipments becomes a prerequisite for dealing effectively with this technique. Considering the attitudes displayed by several of the COCOM countries, not to mention the third countries, it would appear highly unrealistic to expect the requisite cooperation to be forthcoming. In the opinion of the DCN, effective frustration of diversions using this (or other) techniques, will continue to depend upon U. S. efforts to detect impending diversions in time to bring the facts to the attention of -- and to exert pressure on -- the government concerned. This, in turn, depends on the adequacy of our intelligence collection apparatus. (Enforcement intelligence problems are discussed in Section IV below.)

3. Diversions of U. S.-Origin Commodities: the Borax Problem

During the period under review, there was a marked increase in the diversion of U. S.-origin borate products, which attracted some DCN attention because of the impact of the investigations had on the economic defense officers abroad, on the CIA supporting facilities, and on the workload of the BFC Investigation Staff: BFC's Export Control Investigation Staff, for example, estimates that 50% of its time was occupied in enforcement activities involving these commodities. Although borates (e.g., borax, boric acid, etc.) are subject principally to U. S. unilateral control, the diversion problem arises from the fact that borates are not included on the International Lists, and, in consequence, most Western European countries license reexports to the Soviet bloc rather freely. Borate diversions reported during the period were identified as being almost entirely of U. S. origin, which is hardly surprising since the U. S. accounts for over 95% of world production of these materials.

During the period, BFC has taken punitive and corrective-preventive actions against numerous foreign and domestic firms for their participation in borate diversions, and is continuing to gather evidence in a number of unresolved cases. BFC has also conferred with industry representatives and has obtained promises of stricter compliance on the part of major U. S. producer-exporters and their foreign representatives, a procedure which has already had favorable results. It is in the area of domestic sale to -- and export by -- the small non-producing U. S. exporting firm that much remains to be done. This is a difficult situation and is being studied in the Department of Commerce. (Moreover, at the request of JOC, U. S. intelligence agencies are now reviewing all intelligence bearing on the strategic importance of the bloc of borates. Should this review provide a reasonable basis for doing so, it is presumed that an attempt will be made to persuade friendly nations to institute tighter controls over the export of borates to the bloc.)

4. U. S. Military Surplus Property Disposal Abroad

Over the past few years several diversion cases involving U. S. surplus property have come to the attention of the DCM agencies. The most difficult of these cases involved the shipment of automotive spare parts from Egypt to Italy with subsequent resale through an English firm to undeclared final destinations. The prevention of diversions of U. S. military surplus property sold abroad is complicated in most cases by the unique legal status of the equipment at the time of sale and the fact that much of the equipment is not covered by strategic lists. Under these circumstances U. S. surplus is often free of the usual controls over Western-origin goods designed to prevent their diversion to the Soviet bloc (including Communist China).

The situation was brought to a head early this year by a report that twelve carloads of U. S. surplus automotive spare parts were in Basel, possibly destined for the Soviet bloc. Investigation of this case stimulated interested offices in Europe -- i.e., USRO, several of the American Embassies, and the major U. S. military commands -- to work out adequate controls to prevent the diversion of U. S. surplus equipment disposed of by the services overseas. At the same time, the Defense representative on the DCN brought the matter to the attention of the appropriate offices in the Department of Defense. Procedures developed in Europe at a series of conferences coordinated by USRO/ST are now under review by the Departments of Defense, State and Commerce. It is hoped that appropriate instructions to the military commands can be issued in the near future.